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No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

vs.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR ARTHUR YOUNG & COMPANY

CARL D. LIGGIO
General Counsel
Arthur Young & Company
277 Park Avenue
New York, New York 10172
212-407-2367

Counsel for Respondent
Arthur Young & Company

Of Counsel:

JOHN E. MATSON
Associate General Counsel
RICHARD I. JANVEY
Associate General Counsel
ARTHUR YOUNG & COMPANY
277 Park Avenue
New York, New York 10172

September 9, 1983

QUESTION PRESENTED

May the Internal Revenue Service summon tax accrual workpapers which are prepared by an independent auditor in compliance with his responsibilities under the federal securities laws and which disclose the taxpayer's and its auditor's private opinions, theories, legal strategies and possible compromise positions with the Service, where:

1. the Service has access to all the transactional data and other facts needed to determine tax liability from the records of the taxpayer and the audit workpapers of its auditor;

2. there are no allegations of fraud; and

3. the Service has failed to make a showing of substantial need for the tax accrual workpapers or their specific relevance to the correctness of the taxpayer's return, but has relied instead on a claim of convenience?

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ADDITIONAL STATUTE INVOLVED

Fed. R. Evid. 501, prescribed by this Court in 1974 pursuant to 18 U.S.C. §§ 3402, 3771 and 3772 and 28 U.S.C. §§ 2072 and 2075, and approved by Congress, Pub. L No. 93-595, 88 Stat. 1926 (1975), provides in pertinent part that:

> the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience....

STATEMENT OF THE CASE

A. *The Sufficiency of the Data Provided to the Service*

Petitioner's claim that the independent auditor's tax accrual workpapers* contain facts needed to enable the Service to perform its role as tax collector finds no support in the

*Also known as tax cushion or tax contingency reserve files, tax pool analysis and tax liability contingency analysis.

record. On the contrary, the record and the findings of the Court below (which petitioner does not challenge) show:

1. The Service has had access to virtually every piece of paper in Amerada's files relating to its 1972, 1973 and 1974 tax returns. In addition to making its financial and transactional records and those of its banks available to the Service (JA* 64), Amerada responded to more than 398 civil document requests by producing approximately 45,000 pages of documents relating to its returns. (JA 86, 65) The Service also conducted 36 sworn interviews of employees, officers and directors of Amerada. (JA 92) Amerada estimates that between 1975 and 1979 at least 11,500 man hours of personnel time were expended in responding to requests by the Service for information. (JA 64)

2. The "corporation's own books and the audit workpapers [of the independent auditor] furnish the IRS with all the raw data it needs to calculate the taxpayer's tax liability" and "should be sufficient for its purpose of determining the accuracy of Amerada's returns." (PA** 31a, 32a)

3. "There is no factual data relating to Amerada transactions in the tax accrual papers which is not otherwise available in the taxpayer's records or in publicly available documents." (JA 31-32; *see also* JA 38)

B. *The Nature of an Independent Auditor's Tax Accrual Workpapers*

In an attempt to diminish the unique and sensitive nature of an independent auditor's tax accrual workpapers, petitioner fails to describe accurately their contents and their preparation. (*See* Pet. Br. at 3-4, 24-27) Tax accrual workpapers are not prepared in connection with the tax return. (JA 32) They are prepared exclusively for financial disclosure purposes mandated by the federal securities laws and the regulations of the Securities and Exchange Commission ("SEC") thereunder. (JA 32)

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* "JA" refers to the Joint Appendix.

** "PA" refers to the appendix to the Petition for a Writ of Certiorari.

Those laws and regulations require respondent Amerada, a publicly-held corporation, to file with the SEC audited financial statements containing an opinion of an independent public accountant as to whether the statements were prepared in accordance with generally accepted accounting principles.* The independent public accountant must form an opinion regarding the fairness of presentation of the corporation's financial condition, including the adequacy of the stated reserve for potential tax liability.** (JA 27)***

During the process of verifying the tax reserve, the independent auditor reviews the books of account and evaluates the projections, hypotheses and speculations of Amerada's financial officers and legal counsel regarding potential

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*Financial statements must be audited whenever a publicly-owned corporation registers a new stock issue, Securities Act of 1933, Schedule A (25-27), 15 U.S.C. § 77aa (1970); registers securities for listing on an exchange, Securities Exchange Act of 1934, *as amended*, §§ 12 (b)(1)(J)-(L), 12(g)(1), 15 U.S.C. §§ 78*l*(b)(1)(J)-(L), 78*l*(g)(1) (1970); solicits proxies in order to issue securities, modify a class of securities or attempt a merger, Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1976); files annual 10-K reports with the SEC, SEC Form 10-K Instructions as to Financial Statements, 4 Fed. Sec. L. Rep. (CCH) § 31,106; or issues an annual report to shareholders in connection with solicitation of proxies, 17 C.F.R. § 240.14a(3)(b)(3)-(4) (1976).

**The tax reserve is a liability account on Amerada's books which represents an estimate of possible future income tax assessments arising as a result of either (a) the Service's disallowance of deductions or credits previously taken in computing the corporation's tax liability, or (b) certain "timing difference[s]" in the financial as opposed to the tax accounting treatment of certain transactions. (JA 28-33) "The tax contingency figure" on the financial statement "is a composite of possible tax consequences, each discounted by the possibility that it will occur." Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. Tax Rev. 57, 59 (1981).

****See* Financial Accounting Standards Board, *Statement of Financial Accounting Standards* No. 5, 3 Prof. Standards (CCH) AC § 328 (Mar. 1975); American Institute of Certified Public Accountants, *Statement on Auditing Standards* No. 2, 1 [AICPA] Prof. Standards (CCH) AU § 509 (Oct. 1974); No. 17, 1 [AICPA] Prof. Standards (CCH) AU § 328 (Jan. 1977).

tax liability—often on an hypothetical, worst-case basis. (JA 30-32); *see generally* American Institute of Certified Public Accountants, *Statement on Auditing Standards* No. 1, 1 [AICPA] Prof. Standards (CCH) AU § 339.02 (1982). Among the subjects considered are possible issues which might arise as a result of the tax treatment of various corporate transactions; possible objections which the Service might raise in examining Amerada's returns; and possible responses to such challenges, including negotiation strategy, decisions to litigate or compromise, and estimates of the likelihood and outcome of administrative settlements or judicial proceedings which "are based on considerations wholly apart from the inherent legality of what the taxpayer has done, *e.g.*, the cost of litigation and the possibility that confidential business information may be disclosed to competitors." (PA 30a; *see* JA 28-33)

The tax accrual workpapers set forth the taxpayer's and the independent auditor's "speculation as to positions that might be taken by the IRS and the taxpayer, theoretical analysis, and opinions bearing on the fairness and reasonableness of the parties' positions (*as distinguished from factual transactional data*). . . ." (PA 24a) (emphasis added) They record the auditor's and taxpayer's thoughts, opinions and judgments revealed in confidence during the process of verifying the tax reserve. They contain "an item-by-item evaluation of the taxpayer's potential exposure to additional tax liability" if challenged by the Service. Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax. Rev. at 61. If disclosed to the Service, the tax accrual workpapers will provide a definitive "road map" pinpointing "possible vulnerable areas" in the return and announcing "how the corporation will handle the Service and vice versa, if these areas are questioned on audit." (PA 30a)

As the lower Court held, this "case does not involve allegations of fraud," and accordingly "the Service does not need to know taxpayer's thoughts" as recorded in the tax accrual workpapers. (PA 32a, 31a)

C. *The Qualified Privilege Created by the Decision Below*

When the Service summons an independent auditor's tax accrual workpapers, "it creates a clash between two important congressional policies:" protection of the fisc and protection of the investing public from inaccurate financial reporting. (PA 29a, 30a) In resolving the conflict between these competing policies, the Court below decided to tip the balance in favor of safeguarding the integrity of the independent auditing process. (PA 31a)

The Court fashioned a qualified work-product privilege for an independent auditor's tax accrual workpapers which can be invoked only when, as here: (1) the corporate taxpayer's transactional records and books of account (on which, in part, the tax accrual workpapers are based) and its certified public accountant's audit workpapers have been made available to the Service; (2) the corporation's own books and its auditor's audit workpapers furnish the Service "with all the raw data it needs to calculate the taxpayer's tax liability;" (3) there are no allegations of fraud; and (4) there is no showing by the Service of substantial need for the tax accrual workpapers (as in the case of the destruction of corporate records). (PA 31a-32a)

The Court below did not promulgate, or base its decision on the existence of, an accountant-client testimonial privilege in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973). Nor did it announce a general or unlimited accountant's work-product doctrine. The qualified privilege created by the lower Court does not protect communications between an accountant and his client; rather, it shields the specific work product of the independent auditor generated during the process of verifying the tax reserve and only incidentally the testimony of the auditor or taxpayer relating to that process. Since the decision in *Couch* dealt with the question of an accountant-client privilege, which is not at issue in this case, *Couch* is in no way contrary to the decision of the lower Court.

That Court noted that the independent auditor's qualified work-product privilege which it announced is analogous, but

not identical, to the work-product privilege for an attorney's trial preparation materials created by the Court of Appeals for the Third Circuit in *Hickman* v. *Taylor*, 153 F.2d 212 (3rd Cir. 1945), approved by this Court, 329 U.S. 495 (1947), codified in Fed. R. Civ. P. 26(b)(3), and expanded in *Upjohn Co.* v. *United States*, 449 *U.S.* 383, 398-99 (1981). *See also FTC* v. *Grolier, Inc.*, _____ *U.S.* _____, 103 S. Ct. 2209 (1983); *United States* v. *Nobles*, 422 U.S. 225, 236-40 (1975); *NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. 132 (1975).

The Court below emphasized the unfairness to the taxpayer which would result from disclosure to the Service of the taxpayer's settlement positions and its negotiation and legal strategies which are contained in the tax accrual workpapers. (PA 29a-30a) It found that the Service did not need the tax accrual workpapers to complete its tax investigation of Amerada but had summoned them only to marshall "the best arguments for asserting a deficiency." (PA 25a, 31a)

The Court below did not accept the convenience of the Service as a justification for "invading the integrity of the auditing process" or reducing the protection complete financial disclosure provides to the investing public. (PA 31a) It held that the Service is not entitled "to summon a road map of the thoughts and theories of a taxpayer and its independent auditor" merely because it may save the Service time during its audit of Amerada's returns. (PA 31a)

THE FUNDAMENTAL UNFAIRNESS OF PETITIONER'S POSITION

It is common knowledge that the relationship between taxpayers and the Service—whether or not it results in litigation—is adversarial: the taxpayer seeks to minimize while the Service desires to maximize tax liability.

Despite the voluminous documents produced to, and the numerous interviews conducted by, the Service (*see* discussion *supra* at p. 2), petitioner professes a need for access to still more facts which it speculates are contained in the independent accountant's tax accrual work papers. Yet even

now, eight years after the inception of the civil audit (JA 63), petitioner cannot tell the Court what facts the Service needs to complete its investigation of Amerada or explain why this information could not be obtained directly from Amerada's records or financial personnel or from third parties, including the independent auditor's audit (not tax accrual) workpapers—all of which have been made available to the Service. (PA 32a) Petitioner posits certain inquiries the Service might have of a multinational corporation with respect to the "income, expenses, and level of bona fide business activity of an off-shore subsidiary." (Pet. Br. at 24) However, there is nothing in the record to suggest that these inquiries were made of Amerada or that they could not be answered satisfactorily from sources other than the independent auditor's tax accrual workpapers. In any event, the information petitioner claims the Service may need to conduct "a multinational tax audit" (Pet. Br. at 24) is required to be reported to the Service on separate schedules. *See, e.g.*, Form 5471 (Information Return with Respect to a Foreign Corporation) (January 1983) (replacing Forms 957, 958, 959, 2952 and 3646); *see also* I.R.C. § 6038A.

It is obvious, as petitioner ultimately concedes, albeit obliquely, that the Service desires access to the judgmental portions of the tax accrual workpapers for convenience, that is, to assist it in the inherently adversarial process of locating targets for investigation and developing arguments for deficiencies. For example, petitioner states that "[t]he purpose of obtaining tax accrual work papers is not *primarily* to allow the Service access to the accountant's and the taxpayer's 'opinions' and 'theories' about what is the correct tax liability" and that "[t]he Service's *chief* interest is to discover all of the relevant facts—and these workpapers may be of critical importance in allowing it to do so." (Pet. Br. at 26, 27) (emphasis added) (*see also* Pet. Br. at 10, 14, 25)

The Service admits that it seeks access to the tax accrual workpapers because they provide a "roadmap through the raw data" and "embody the taxpaper's and the accountant's judgments about which facts are *relevant* to the taxpayer's lawful tax liability." (Pet. Br. at 26) Yet, when the situation

is reversed, and a taxpayer seeks information from the Service under the Freedom of Information Act regarding its private thoughts, opinions, analyses and negotiating, litigation and settlement positions concerning the taxpaper, the Service tries to "enshroud [them] in secrecy" (Pet. Br. at 33) and generally prevails.

In those cases, the Service seeks a very expansive definition of material exempt as "tax return information" under 26 U.S.C. § 6103(e)(7). *See, e.g., White* v. *IRS*, 707 F.2d 897 (6th Cir. 1983). The Service also receives the benefit of a "highly deferential" standard of review of its discretion, and is upheld "so long as [its] determination is rational and has support in the record." *Zale Corp.* v. *IRS*, 481 F. Supp 486, 489 (D.D.C. 1979). Under this criterion, the Service may withhold virtually anything which it claims will "seriously impair tax administration" (26 U.S.C § 6103 (e)(6)) or "impair the IRS' ability to present its best case both during the administrative process as well as during litigation. . . ." *Anheuser-Busch, Inc.* v. *IRS*, 493 F. Supp. 549, 551 (D.D.C. 1980); *see also P.T. & L. Construction Co.* v. *Commissioner*, 63 T.C. 404 (1974) (limiting taxpayer's discovery of the Service in the Tax Court); *Esson* v. *Commissioner*, [1975] T.C.M. (P-H) ¶ 75,121.

Thus, petitioner espouses one rule for the taxpayer and the Service espouses another for itself.

In an adversarial process such as this, it is "fundamentally unfair" for one side to have access to the other side's private musings, ruminations, speculations, plans and strategies for conduct of the combat and for the other side to be completely foreclosed from access to the same type of information from its adversary. This Court has recently reaffirmed that despite the general rule that a litigant is entitled to "every man's evidence," specific exceptions are mandated on grounds, among others, of "fundamental fairness." *United States* v. *Sells Engineering, Inc.*, ____ U.S. ____, 51 U.S.L.W. 5059, 5063 (June 30, 1983). This principle has also recently been applied against the Service in the context of a civil audit.

United States v. *Baggot*, ____ U.S. ____, 51 U.S.L.W. 5075 (June 30, 1983).

In *United States* v. *Sells Engineering, Inc.*, *supra*, this Court held that automatic disclosure to government attorneys of grand jury materials for civil use posed "a significant threat to the integrity of the grand jury itself," made "more concrete the threat to the willingness of witnesses to come forward and to testify fully and candidly" and subverted "the limitations applied outside the grand jury context on the Government's powers of discovery and investigation." (51 U.S.L.W. at 5063) It warned that:

> If government litigators or investigators in civil matters enjoyed unlimited access to grand jury materials, there would be little reason for them to resort to their usual, more limited avenues of investigation. To allow these agencies to circumvent their usual methods of discovery would not only subvert the limitations and procedural requirements built into those methods, but would grant to the Government a virtual *ex parte* form of discovery from which its civil litigation opponents are excluded unless they make a strong showing of particularized need.

(*Id.*). In *United States* v. *Baggot*, *supra*, this Court reiterated that warning, holding that since a civil audit was not "preliminary to litigation," the Service could not gain access to confidential grand jury materials. (51 U.S.L.W. at 5076)

These determinations are particularly apposite to this case. If the Service is granted routine access to tax accrual workpapers, it will represent a significant expansion of the Service's "usual methods" of conducting audits. *United States* v. *Sells Engineering, Inc.*, *supra*, 51 U.S.L.W. at 5063. "After all, for a great many years the Service effectively employed its summons powers in routine audits. . . . of large corporate taxpayers without the necessity of attempting to acquire their 'tax pool' analyses." *United States* v. *El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

Access by the Service to the tax accrual workpapers places the taxpayer in a position of unequal bargaining power with the Service and seriously undermines the taxpayer's ability to strike reasonable settlements with the Service on good faith estimates. (JA 31-32) For an examining revenue agent, access to the independent auditor's tax accrual workpapers provides an attractively easy basis for challenging the taxpayer on the issues flagged in those documents. Moreover, by asserting such issues in a statutory notice, the Service enjoys the benefit of presumptive correctness and burdens the taxpayer with the risks and expense of litigation.

The Court below recognized correctly that:

> In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving in a little. Such negotiations strike an appropriate balance between collecting revenue and conserving judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.

(PA 29a, 30a) It also realized that divulging the information contained in the tax accrual workpapers "necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited." (*Id.*) Accordingly, the Court concluded that:

> The prejudice involved in exposing to the Service appraisals of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.

(PA 30a)

Moreover, if the Service can breach the confidentiality of the tax reserve verification process and use the tax accrual workpapers as its own audit plan, the accounting profession will be perceived as, and will effectively become, an auxiliary enforcement arm of the Service. This result was not intended by Congress. *See* Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. Tax'n 194, 199-200 (1979); *see also United States* v. *Humble Oil &*

Refining Co., 518 F.2d 747, 748-49 (5th Cir. 1975) (compelling private citizens to do the Service's research exceeds the scope of § 7602 summons); *cf. SEC* v. *Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979) (refusal to conscript accountants in enforcing existing securities laws according to SEC views); *SEC* v. *Touche Ross & Co.*, 438 F. Supp. 259, 262 (S.D.N.Y. 1977) (declining to enforce the request by the SEC to support its "auditing efforts with those of an independent accountant.")

SUMMARY OF ARGUMENT

1. The Service's broad summons power under 26 U.S.C. § 7602 is subject to limitation, particularly when enforcement would undermine the goals of another federal statute. Accordingly, the Service's claim of administrative convenience must be evaluated in light of the adverse impact that disclosure of the tax accrual workpapers will or may have on the accuracy and completeness of financial reporting required by the federal securities laws and regulations on which the investing public depends.

2. Unrestricted access by the Service to tax accrual workpapers will undermine effective enforcement of the federal securities laws. The present and a former Commissioner of Internal Revenue have recognized that mandatory disclosure of an independent auditor's tax accrual workpapers will have a chilling effect on the quality of financial disclosure under the federal securities laws. This is not to assume that publicly-held corporations will deliberately shirk their financial reporting responsibilities. Rather, the chilling effect will be manifested in a more conservative approach to identifying questionable tax positions for inclusion in the tax reserve. The end result is that certified public accountants will have less information to work with, and the reports they issue for the investing public's benefit will be less accurate and complete.

3. Because it found that the Service did not need the tax accrual workpapers to complete its tax audit of Amerada, the Court below, following established authorities for resolving conflicts between federal statutes, weighed the beneficial

effects of disclosure to the investing public of the "data generated as a result of the SEC laws" more heavily than the Service's convenience. (PA 28a, 29a)

4. The lower Court's decision creating a qualified privilege for an independent auditor's tax accrual workpapers is fully supported by Rule 501 of the Federal Rules of Evidence and the analogy to the attorney's work-product privilege.

5. The decision of the lower Court should be affirmed because it resolved the conflict between competing congressional policies with minimal disruption to the exercise of the Service's summons authority while protecting the investing public and the integrity of the independent auditing process and insuring fair and reasonable treatment of the corporate taxpayer.

6. The Court below recognized that the "Service's emerging practice of requesting tax accrual workpapers" was, in effect, an attempt to force corporate taxpayers to "flag their questionable positions" as suggested by former Commissioner Kurtz. (PA 25a, 31a-32a) Shortly after the judgment below was entered, Congress adopted some of former Commissioner Kurtz's suggestions in section 323(a) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324 (to be codified at 26 U.S.C. § 6661). Section 6661 specifies what the taxpayer should disclose to the Service—the relevant facts relating to positions for which there may not be substantial authority. It does not require disclosure of the thoughts, opinions and judgments of the independent auditor and taxpayer which are contained in the tax accrual workpapers, and which are shielded from discovery by the Service. By seeking tax accrual workpapers, the Service is attempting to exceed Congress's recent limitation on the scope of section 7602 summons authority.

7. There are also alternative grounds for affirming the decision below: a) the tax accrual workpapers are not relevant to the Service's civil audit of Amerada; and b) the tax accrual workpapers do not contain purely factual data encompassed by 26 U.S.C. § 7602. The Court below rejected these arguments and held that any documents that "might throw

light upon" the accuracy of a taxpayer's return are relevant to an audit by the Service. (PA 27a) In other cases courts have held that a stricter standard of relevance applies when the Service seeks access to materials containing theories and opinions as opposed to transactional data, particularly when the information is sought from a third party rather than the taxpayer. This standard has been variously interpreted as requiring a showing of "sufficient relevance" or a "realistic expectation of relevance," as opposed to a claim of administrative convenience. In addition, section 7602 should be limited to purely factual data.

8. The more stringent standard of relevance has been adopted by the Service's own revised guidelines for requesting access to tax accrual workpapers. However, the Service has failed in this case to satisfy its own standard.

ARGUMENT

I.

THE COURT BELOW DID NOT ERR IN CREATING A QUALIFIED PRIVILEGE FOR THE TAX ACCRUAL WORKPAPERS OF AN INDEPENDENT AUDITOR SINCE ACCESS BY THE SERVICE WILL INHIBIT THE QUALITY AND DEPTH OF FINANCIAL REPORTING TO THE INVESTING PUBLIC REQUIRED BY THE SECURITIES LAWS

The Service has been given broad authority under section 7602 to summon the production of "books, papers, records, or other data which may be relevant or material" to a determination of a taxpayer's income tax liability. This power provides an important check on taxpayer compliance with the nation's self-assessment tax system. Nevertheless, like all broad grants of authority, the power of the tax collector is subject to abuse and should be kept within proper bounds. *See United States* v. *Bisceglia*, 420 U.S. 141, 151 (1975).

To limit the potential for abuse, Congress did not make the Service's summonses self-executing, but interposed the supervisory authority of the federal courts. *See* 26 U.S.C.

§ 7604(b); *Reisman* v. *Caplin*, 375 U.S. 440 (1964). This Court has determined that a summons will not be enforced unless the Service makes a preliminary showing:

> that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed.

United States v. *Powell*, 379 U.S. 48, 57-58 (1964).

In each case, as this Court has held, the court must be satisfied that the summons "is necessary for the effective enforcement of the revenue laws *and is not undercut by contrary legislative purposes.*" *United States* v. *Euge*, 444 U.S. 707, 715-16 & n.9 (1980) (emphasis added).

A. *The Countervailing Legislative Policies*

The Court below recognized that there are substantial countervailing policies enunciated by Congress which favor the protection of "the work that independent auditors, retained by publicly-owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers." (PA 28a) It emphasized that:

> When the IRS chooses to regularly summon tax accrual workpapers, it creates a clash between two important congressional policies. No matter how we decide this issue, one policy has to bend a bit. Giving the complete latitude to the summons power that the IRS seeks here compromises the procedure designed by Congress to protect the investing public from inaccurate financial information. Protecting the accuracy of the securities laws dilutes the power of the Service to summon a roadmap of the thoughts and theories of a taxpayer and its independent auditor.

(PA 30a-31a)

The clash between administrative convenience in the conduct of tax investigations and the protection of the investing public from inaccurate and incomplete financial reporting was resolved in favor of "the independent auditing process."

(PA 30a, 31a) The Court reasoned that the Service had access to "all the raw data that it needs to calculate the taxpayer's tax liability" whereas the "investing public . . . relies most exclusively on the data generated as a result of the SEC laws." (PA 31a)

Petitioner maintains that the Court below "erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection." (Pet. Br. at 12, 42) In particular, petitioner questions the Court's assumption "that production of tax accrual workpapers would cause corporations to withhold information from their outside auditors." (Pet. Br. at 39-40) This assertion defies common sense, the record below (JA 32) and the compelling evidence of a chilling effect from mandatory disclosure of tax accrual workpapers which has appeared in the legal and financial press.

No better authority for rebutting petitioner's position and emphasizing the need for judicial resolution of the conflicting public policy considerations can be found than Commissioner Roscoe L. Egger's public remarks on the tax accrual workpapers' issue when the Service's revised manual guidelines were announced in May, 1981. Explaining the reasons for the revisions, Commissioner Egger admitted that:

> We began to hear that our requests for [tax accrual workpapers] were driving a wedge between CPAs and their clients. We heard that situations were being encountered where clients were no longer preparing tax accrual information or were refusing to grant access by the independent auditors since the IRS could then gain access to this information. Ultimately this situation led to the pronouncement by the AICPA's statement on auditing standard 31 on the effect of an inability to obtain evidential matter relating to income tax accrual. This matter also was of concern to the Securities and Exchange Commission since their desire was for full financial disclosure. The CPAs were in a quandry [sic] over this situation since generally accepted auditing standards required a consideration of Federal income taxes. As a result, the AICPA

> formed a special task force on the issue. The subject continued to be one of interest at tax seminars and drew comments in *The Wall Street Journal* and *Business Week* in addition to accounting and tax publications. We in the IRS who are responsible for policy became very concerned because the issue had reached rather emotional proportions and also had real potential for serious negative effects on the quality of financial reporting.

Daily Report for Executives, DER No. 86 (BNA), May 5, 1981, at J-1.*

A former Commissioner of Internal Revenue, Mortimer Caplin, has concluded that:

> The policy arguments for limiting the Service's access to accountants' tax accrual workpapers are persuasive. Candid communication between accountant and client is at stake, as well as protection of the integrity of the financial audit process and the public interest in full disclosure in corporate financial statements. An additional concern is the adverse impact of the tax accrual controversy on the nation's self-assessment system. The federal income tax system is based upon cooperation by the public through voluntary compliance and self-assessment of taxes. To preserve this process, the Service must treat taxpayers in a fair, evenhanded manner, and demonstrate to the public that it is doing so. To this end, the Service depends on the cooperation and backing of both tax lawyers and accountants. It serves the best interests of the Service, therefore, to

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See also Buchholz, *Tax Accrual File Controversy: Legal Problems Facing the Accountant*, 40th Ann. Inst. on Fed. Tax'n § 37.01, at 14-16 (1982); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 Ford. L. Rev. 468, 484 (1982); Hanson & Brown, *CPAs' Workpapers: The IRS Zeros In*, 152 J. Accountancy 68 (July 1981); *IRS to Clarify Rules Limiting Agents Probe of Tax Workpapers*, 151 J. Accountancy 8 (May 1981); *Interpretation Guides Auditor Who Cannot Obtain Evidence on Income Tax Accruals*, 151 J. Accountancy 18, 20 (Mar. 1981); Rout, *Auditors Say IRS Demand for Documents is Poisoning Relations with Client Firms*,

(footnote continued on following page)

> treat these professionals with respect and to assist them in resolving problems that relate to administration of the tax law.
>
> Access to tax accrual files certainly is not uppermost among the needs of the Service. It faces problems of a much broader and more pressing nature. Consideration of the proper ranking of Service priorities, especially in light of the policy issues at stake, calls for an institutional effort to defuse the tensions that have developed over the tax accrual issue.

Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax. Rev. at 81-83. (footnotes omitted)

In addition, in May 1980 the Justice Department's Advisory Committee on Tax Litigation, which was investigating standards for seeking accountants' tax accrual workpapers, issued a report in which it recommended that there were "strong policy reasons to be taken into account for" prohibiting summonses for tax accrual workpapers except "in special cases." Justice Department Advisory Committee on Tax Litigation, *Report of the Committee on Standards for Seeking Accountants' Tax Accrual Workpapers, Daily Report for Executives*, DER No. 100 (BNA), May 20, 1980, at J-10, 11. The Justice Department Advisory Committee also suggested that "an enforcement action for tax accrual workpapers" be brought only "where there is a reasonable belief that the workpapers would disclose facts or circumstances relating to a particular transaction or transactions where such facts or circumstances are not otherwise available or apparent through the normal audit procedure." *Justice Department Advisory Committee Report, supra*, DER No. 100, at J-11.

(footnote continued from preceding page)

Wall St. J., Jan. 15, 1981, at 25, cols. 4-6; *A Losing Fight to Shield Company Tax Secrets*, Bus. Week, June 16, 1980, at 117.

B. *The Chilling Effect of Mandatory Disclosure of Tax Accrual Workpapers*

Mandatory disclosure of tax accrual workpapers will have a chilling effect upon the efficacy of the independent auditor's verification of the tax reserve and hence the accuracy of the financial information available to the investing public. The testimony of an accounting expert in *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), vividly describes the constraints interfering with the accountant's performance of his duty:

> [W]hat I'm concerned about is the ability of the Government to look into the client's mind to determine not what the facts are on which the tax is based, but what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.
>
> He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with, and with that information available to the revenue agent just for the asking, I think it would terribly impede and I think eventually destroy the system of auditing that we have established because it would eliminate the freedom that the client feels of being able to muse with us about, well, what if this capital gains is treated as an ordinary income? What are the potentials? What are the chances? Well, the chances are 60-40 or 90-10, one way or the other.
>
> * * *
>
> Now, these are the kinds of problems which we are continually in contact with our client about, are advising the client, are getting his feedback. If we were hampered in any audit situation by the fact that the client knows that if he gives us any data about that that it's going to be readily available to the Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication, and if I were the client, I would be the first to admit that that is the way I would feel.

> I can't see how he can talk to me freely—I'm talking now only about opinions and ideas and thoughts and nightmares, if you will.

(413 F. Supp. at 953-54; *see also* JA 32)

Petitioner argues that the corporate taxpayer's risk of incurring penalties is sufficient to insure compliance with the securities laws. (Pet. Br. at 40-43) This position exaggerates the power of SEC enforcement to encourage complete tax contingency disclosure. It fails to recognize, for example, that the scope of the questions asked, the candor of the answers given and the completeness of the review of supporting records during the independent auditor's verification of the tax reserve can vary "without necessarily violating SEC disclosure requirements." *See* Jacobson & Steel, *The Auditor Work-Product Privilege: The Fifth Circuit Spurns the Second Circuit's Creation of a Novel Privilege*, 16 Rev. of Sec. Reg. 891, 898 (1983).

In *Upjohn Co.* v. *United States, supra*, this Court rejected the same argument petitioner asserts here: "This response ignores the fact that the depth and quality of any investigations to ensure compliance with the law would suffer, even were they undertaken." (449 U.S. at 393 n.2) In *Upjohn*, this Court held that fear of civil or criminal liability would not necessarily lead corporations to conduct thorough internal investigations and seek appropriate legal advice, and concluded that the protection of the attorney-client privilege was needed to provide the requisite, additional incentive. (*Id.*)

Even though most corporations may still try to satisfy fully the disclosure requirements of the securities laws, the risk of discovery by the Service of their planned negotiating positions will lead some to make more conservative and less complete assessments of what tax positions on their return are "questionable." *See generally* Note, *Protecting the Auditor's Work Product from the IRS*, 1982 Duke L.J. 604, 616. As a result, the integrity of the independent auditor's process of verifying the tax reserve during its yearly audit of the corporation's financial statements—which the SEC has described as one of the principal protections for investors

"from inadequate or improper financial reporting" —will be correspondingly diminished. *See* SEC, *Forty-Third Annual Report* 110 (1977).

C. *Standards for Judicial Resolution of Competing Congressional Policies*

Conflicts between competing statutory schemes are grist for the judicial mill. *See, e.g., Watt* v. *Alaska*, 451 U.S. 259, 266-67 (1981). In holding that the antitrust laws must give way to certain self-regulatory provisions of the Securities Exchange Act, for example, this Court ruled:

> As a threshold matter, we believe that the determination of whether implied repeal of the antitrust laws is necessary to make the Exchange Act provisions work is a matter for the courts; . . . .

Gordon v. *New York Stock Exchange*, 422 U.S. 659, 686 (1975) (citing *Ricci* v. *Chicago Mercantile Exchange*, 409 U.S. 289, 306-08 (1973)). Similarly, in *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963), this Court recognized that the interrelationship between the antitrust laws and the securities laws "must be discerned as a matter of implication" and statutory construction, the traditional techniques of interpretation which courts have regularly employed. (373 U.S. at 357)

Ignoring these established principles, petitioner emphasizes the general rule of construction that the judiciary should give effect to all federal statutes so long as they are "capable of coexistence." (Pet. Br. at 44) (citing *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133-34 (1974)) The general rule, however, is of little assistance in this case, which turns on an unavoidable clash between the securities and internal revenue laws.

Petitioner also misconstrues *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), as supporting its contention that, absent specific statutory provision mandating confidentiality of tax accrual workpapers, they must be produced pursuant to a summons by the Service. In *St. Regis* this Court held that a confidentiality provision in the Census Act, § 9(a),

13 U.S.C. § 9(a), did not preclude enforcement of a disclosure request by the Federal Trade Commission. (368 U.S. at 217-19)

St. Regis is inapposite not only because the disclosure request was not addressed to a third party but also because the census data at issue consisted of facts, not thought processes disclosing a company's position for negotiations with a government agency. Thus, there was little or no risk of a chilling effect undermining enforcement of the Census Act and justifying the creation of a new privilege. (368 U.S. at 216-18) Moreover, in *St. Regis* this Court did not have to tip the balance between competing congressional policies because it found no potential conflict. (*Id.* at 218-20)

Petitioner also fails to recognize the fallacy of its own reasoning that if there is a conflict of congressional policies, it should be resolved by Congress, not the judiciary. (Pet. Br. at 43-44) If this Court resolves the conflict in congressional policies by enforcing the summons, as sought by petitioner, the judiciary rather than Congress will still be making the policy choice—this time in favor of the Service. Petitioner does not really disagree with the source of the decision, but rather with the resolution of the conflict made by the Court below.

D. *The Lower Court's Resolution of the Competing Legislative Policies*

Faced with the clash of congressional policies, the Court below recognized a qualified privilege to protect the work of independent auditors in preparing tax accrual workpapers. (PA 30a, 31a) Congress expressly authorized judicial creation of new privileges under these circumstances in Fed. R. Evid. 501: "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." (Pub. L. No. 93-595, 88 Stat. 1926

(1975))* These privileges become part of the common law and, as in *Upjohn*, "serve to limit the scope of the IRS' power." (PA 28a) (citing *Upjohn Co. v. United States, supra*, 449 U.S. at 398-99; *United States* v. *Euge, supra*, 444 U.S. at 714) Petitioner's criticism of the decision below ignores Fed. R. Evid. 501. Fed. R. Evid. 501 is the complete answer to the argument of the dissenting opinion in the lower Court that the issue of privilege should be left to Congress. (PA 33a-34a) Congress has authorized the courts to decide that issue.

1. *Fed. R. Evid. 501*

Prior to the enactment of the Federal Rules of Evidence, all privileges in the federal courts had been either created or adopted by the judiciary in the course of resolving conflicting policies favoring and discouraging disclosure of information sought to be protected. *See, e.g., United States* v. *Nixon*, 418 U.S. 683, 708 (1974) (presidential communications are presumptively privileged because of chief executive's need to be "free to explore alternatives in the process of shaping policies and making decisions and to do so in a way many would be unwilling to express except privately"); *Wolfle* v. *United States*, 291 U.S. 7 (1934) (privilege protecting the marital relationship); *Hickman* v. *Taylor, supra*, 329 U.S. 495 (recognizing attorney's work-product privilege).

This Court has observed that in enacting Fed. R. Evid. 501, Congress "manifested an affirmative intention not to freeze the law of privilege" but rather to " 'provide the courts with flexibility to develop rules of privilege on a case-by-case basis' and to leave the door open to change." *Trammel* v. *United States*, 445 U.S. 40, 47 (1980) (quoting statement of Rep.

* The language of Rule 501 was drawn from then existing Fed. R. Crim. P. 26, which provided that the privilege of a witness was governed by the common law as interpreted "in the light of reason and experience." Fed. R. Crim. P. 26 was relied upon as a congressional invitation to the courts to create or modify privileges based on modern circumstances. *See, e.g.*, Mullen v. United States, 263 F.2d 275 (D.C. Cir. 1958) (priest-penitent privilege); In re Verplank, 329 F. Supp. 433 (C.D. Cal. 1971) (expansion of physician-patient privilege).

Hungate at 120 Cong. Rec. 40891 (1974)); *see also Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 396-97; *United States* v. *Gillock*, 445 U.S. 360, 367 (1980).

The legislative history of Fed. R. Evid. 501 confirms "that Congress anticipated future recognition, by the courts, of privileges not recognized at the time of passage of the Rule." Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. Tax'n 66, 68 (1982); *see* S. Rep. No. 1277, 93d Cong., 2d Sess. 12-13 (1974); 2 D. Louisell & C. Mueller, *Federal Evidence* § 200 (1978); 23 C. Wright & K. Graham, *Federal Practice and Procedure: Evidence*, § 5425 (1980).

Under Rule 501's "reason and experience" standard, federal courts have created or expanded some privileges and have rejected or narrowed others based on a balancing of competing disclosure policies.* This Court, for example, declined to create a new privilege where it found that no important policy supersedes the right of the public to "everyman's evidence." *See United States* v. *Gillock*, *supra*, 445

*For decisions creating or modifying privileges, *see* In re Subpoena Served upon Zuniga, No. 82-1906, Slip Op. (6th Cir. Aug. 3, 1983) (qualified psychotherapist-patient privilege); Gray v. Board of Higher Educ., 692 F.2d 901 (2d Cir. 1982) (votes of college tenure committee); In re Grand Jury Matter, 673 F.2d 688 (3d Cir.), *cert. denied sub nom.* United States v. Doe, ___U.S.___, 103 S. Ct. 375 (1982) (adverse spousal testimony); United States v. Green, 670 F.2d 1148 (D.C. Cir. 1981) (narcotics surveillance location); Riley v. City of Chester, 612 F.2d 708 (3d Cir. 1979) (newspaper reporter's sources); In re Agosto, 553 F. Supp. 1298 (D. Nev. 1983) (parent-child communications); O'Connor v. Chrysler Corp., 86 F.R.D. 211 (D. Mass. 1980) (self-evaluation of affirmative action plans). For decisions rejecting new privileges, *see, e.g.*, Memorial Hospital v. Shadur, 664 F.2d 1058 (7th Cir. 1981) (hospital disciplinary proceedings); American Civil Liberties Union v. Finch, 638 F.2d 1336 (5th Cir. 1981) (records of state commissions); Gannet v. First Nat'l State Bank, 546 F.2d 1072 (3d Cir. 1976), *cert. denied*, 431 U.S. 954 (1977) (attorney's escrow accounts); Kaufman v. Edelstein, 539 F.2d 811 (2d Cir. 1976) (expert witnesses); In re International Horizons, Inc., 689 F.2d 996 (11th Cir. 1982) (accountant-client privilege in bankruptcy proceedings); Ott v. St. Luke Hospital, 522 F. Supp. 706 (E.D. Ky 1981) (medical peer review committees).

U.S. at 360 (speech and debate privilege for state lawmakers).

But where—as here—critical policy objectives favoring confidentiality in the decision-making process would be compromised by public disclosure, this Court has not hesitated to tip the balance of competing interests in favor of confidentiality by recognizing a qualified privilege. *See, e.g., United States* v. *Nixon, supra*, 418 U.S. at 683; *see also Kerr* v. *United States*, 426 U.S. 394, 405 (1975) (disclosure would "chill the free and uninhibited exchange of ideas" within a state's prison-parole system). The lower federal courts have utilized a similar balancing process in creating new privileges pursuant to Fed. R. Evid. 501. In *EEOC* v. *University of Notre Dame DuLac*, the Court of Appeals for the Seventh Circuit, announced a qualified academic freedom privilege prohibiting disclosure of the names or identities of persons participating in the peer review process on the ground that the need for "frank and unrestrained critiques and discussions" was paramount in the circumstances. *Daily Labor Reporter*, DLR No. 166 (BNA), D-1, D-3 (7th Cir. Aug 17, 1983). Another federal court, deciding a class action securities fraud suit, recognized a new limited privilege protecting the work of a special officer, an attorney, retained by the corporation to investigate questionable accounting and auditing practices which had led to an SEC complaint. *In re LTV Securities Litigation*, 89 F.R.D. 595 (N.D. Tex. 1981). Like the Court below, these courts recognized new qualified privileges after weighing plaintiff's right to discovery against a competing congressional policy encouraging defendant to take steps to ensure compliance with applicable laws.*

2. *The Analogy to the Attorney's Work-Product Privilege*

Contrary to petitioner's view (Pet. Br. at 11, 29-36), the lower Court was not attempting to create a privilege that

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* *See also* Note, *The Privilege of Self-Critical Analysis*, 96 Harv. L. Rev. 1083 (1983); Murphy, *The Self-Evaluative Privilege*, 1982 J. Corp. L. 489, 491-92 (1982); McClain v. Mack Trucks, Inc., 85 F.R.D. 53 (E.D. Pa. 1979) (refusing to permit

(footnote continued on following page)

would track the attorney's work-product privilege detail for detail. There is no dispute that, as a general matter, documents generated by independent auditors are not prepared in anticipation of litigation because auditors are not lawyers and, therefore, do not litigate. Petitioner, in effect, contends that there can be no work-product privilege for professionals other than attorneys. That contention begs the question.

The federal courts created the attorney's work-product doctrine to prevent an abuse of the newly liberalized discovery rules. *See generally* Note, *The Work Product Doctrine in Subsequent Litigation*, 83 Colum. L. Rev. 412, 415-419 (1983). The documents at issue in *Hickman*—an attorney's notes of interviews of witnesses—were not "privileged or irrelevant." (329 U.S. at 509) Their protection against disclosure was based on the fact that their "[p]roper preparation . . . is the historical and necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to promote their clients' interests." (329 U.S. at 511; *see* PA 28a) "Discovery," as Justice Jackson emphasized in his concurring opinion, "was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary." (329 U.S. at 516)

Recognizing that "it is essential that a lawyer work with a certain degree of privacy," this Court in *Hickman* reasoned that if discovery of the attorney's trial preparation materials were allowed

> much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate,

(footnote continued from preceding page)

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discovery of affirmative action plan); Stevenson v. General Electric Co., 26 Fed. R. Serv. 2d 574 (S.D. Ohio 1978) (affirmative action plan); Bredice v. Doctors Hospital, Inc., 50 F.R.D. 249, 250 (D.D.C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973) (reports and minutes of defendant hospital's staff meetings concerning the death of plaintiff's decedent were protected by a qualified privilege because "[c]andid and conscientious evaluation of clinical practices is a *sine qua non* of adequate hospital care"). *But see* FTC v. TRW, Inc. 628 F.2d 207, 210 (D.C. Cir. 1980); United States v. Noall, 587 F.2d 123, 126 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

> would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.

(329 U.S. at 511)

In *Upjohn* this Court relied on Fed. R. Evid. 501 to apply the attorney-client and work-product privileges in the context of limiting the Service's summons authority. (449 U.S. at 396-97) The documents at issue in *Upjohn* were prepared by counsel in the course of an internal investigation of questionable payments. As is the case with tax accrual workpapers, the investigation in *Upjohn* was an independent effort to evaluate the corporation's record of compliance with particular statutory requirements.

In *Upjohn*, as here, the Service attempted to summon opinion matter rather than factual data. The Service also contended that its own convenience was sufficient grounds for requiring disclosure of the summoned documents. This Court emphatically disagreed, concluding that "a far stronger showing of necessity and unavailability by other means than was made by the government . . . in this case would be necessary to compel disclosure." (*Id.* at 402) Even though the documents at issue—attorneys' memoranda based on interviews with Upjohn employees world-wide—were likely to provide the Service with useful information in an organized, convenient form, this Court emphasized that it was more important to preserve the confidentiality of the attorneys' thought processes recorded in their summaries of these meetings. (*Id.*)

The lower Court recognized the need for the same kind of protection when it created a qualified privilege for tax accrual workpapers to safeguard the public interest against " 'the grave dangers of inaccuracy and untrustworthiness' . . . that would result" in the independent auditing process if such documents "were routinely revealed to the Service." (PA 31a) (quoting *Hickman*, 329 U.S. at 5)

> If the auditor were required to disclose this material, which is not used in the preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpaper's obligations under federal securities laws.

(PA 24a-25a) *See, e.g.*, Fishman, *Intentional Destruction of Tax Workpapers: An Analysis of a Relatively Uncharted Area*, 58 J. Tax'n 214 (Apr. 1983); *see generally*, AICPA, Auditing Standards Division, *The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*, 151 J. Accountancy 122 (Mar. 1981).

In evaluating the adequacy of a tax reserve the auditor must, in effect, present the best case which the Service might make against the taxpaper. (*See* PA 24a, 30a; JA 31) In this context, the claim that the independent auditor, as an "instrument of public oversight," expects that his thought process will be open to the public (Pet. Br. at 30), is fatuous. Such opinions and speculations do not represent the auditor's "bottom line" judgments but his worst-case imaginings. Accountants are not permitted to disclose them to the public, and the taxpaper is entitled to an expectation of confidential treatment of its communications with the auditor. *See, e.g.*, AICPA *Code of Professional Ethics*, Rule 301 (1973) ("A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client."). Their forced disclosure would destroy the "integrity and objectivity" which a public accountant needs to maintain his independent relation to his client. AICPA, *Professional Standards*: ET § 52.01 (CCH) (1981) (Code of Ethics).

The fact that the independent auditor's ultimate judgment as to the adequacy of the tax reserve is made public in the audited financial statement does not mean that the entire analytical process on which that judgment is based should be disclosed. An attorney, for example, will make his strategy public as the trial unfolds in the courtroom, but no adversary

is permitted to discover that strategy in advance or the judgments, opinions and thought processes on which it is based.

Petitioner also contends that the disclosure of an independent auditor's tax accrual workpapers should not be prevented, because unlike an attorney's work product, it is "common for accountants to disclose their clients' confidential communications and their own work product in order to demonstrate that they properly discharged their duties to all." (Pet. Br. at 32) The argument is flawed because it relies on cases in which accountants themselves were accused of fraud and opened their books to defend themselves. *Oleck* v. *Fischer*, 623 F.2d 791 (2d Cir. 1980) (accounting firm allegedly prepared a "fraudulently misleading" financial statement); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976) (securities purchaser contended that the audit was "materially and knowingly misleading"); *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976) (civil action alleging violations of the fraud provisions of the securities statutes).

These cases constitute an exception, not the general rule, with respect to the independent auditor's obligation to respect client confidences. They correspond to the instances in which a lawyer accused of unprofessional conduct or malpractice is permitted to disclose confidential information received from clients. *ABA Model Code of Professional Responsiblity*, DR4-101(C)(4)(1978) ("A lawyer may reveal. . . confidences or secrets necessary to establish or collect his fee or defend himself or his employees or associates against an accusation of wrongful conduct."); *see, e.g.*, *Condon* v. *Petacque*, 90 F.R.D. 52 (N.D. Ill. 1981).

3. *The Limited Scope of the Privilege Created by the Lower Court*

Contrary to petitioner's assertions (Pet. Br. at 11-12, 35-37), the qualified privilege announced by the lower Court is not a broad testimonial accountant-client privilege running afoul of this Court's decision in *Couch* or the decisions of the lower courts following *Couch*. *See, e.g.*, *In re International Horizons, Inc.*, *supra*, 689 F.2d at 1004. Like the attorney's

work-product privilege, the independent auditor's privilege primarily protects "documents and tangible things"—in this case only the tax accrual workpapers of the independent auditor—not all communications between the auditor and client. The protection is also limited to the work product of the independent auditor—not that of the taxpayer. Accordingly, the privilege belongs to the independent auditor—not the taxpayer. In short, the independent auditor's work-product privilege is as different in its rationale and scope as the attorney's work-product privilege is from the attorney-client privilege. Moreover, lower courts have interpreted the decision below not as creating an accountant-client communication privilege but a qualified privilege for that part of an independent auditor's work-product which consists of tax accrual workpapers. *See, e.g., United States* v. *Haller*, 83-1 U.S.T.C. ¶ 9130 (D. Conn. 1983).

Nevertheless, like the attorney's work-product privilege, the independent auditor's qualified privilege necessarily must have some incidental aspects of testimonial immunity. In *Hickman* this Court observed that "forcing an attorney to repeat or write out all that witnesses have told him and to deliver the account to his adversary gives rise to grave dangers of inaccuracy and untrustworthiness. No legitimate purpose is served by such production." (329 U.S. at 512-13) *See, e.g., Yoffe* v. *Keller Industries, Inc.*, 580 F.2d 126, 131 n. 12 (5th Cir. 1978), *cert. denied*, 440 U.S. 915 (1979) (testimonial immunity for attorney's mental impressions and legal theories); *Ford* v. *Philips Electronics Instruments Co.*, 82 F.R.D. 359 (E.D. Pa. 1979); *Bercow* v. *Kidder, Peabody & Co.*, 39 F.R.D. 357, 358 (S.D.N.Y. 1965); *see generally* 8 C. Wright & C. Miller, *Federal Practice & Procedure: Civil* § 2026, at 230-232 (1970). The thoughts, theories, opinions and judgments of the independent auditor with respect to the corporate taxpayer's tax reserve should be protected against disclosure during oral examination to the same extent as the tax accrual workpapers themselves. Otherwise, the protection afforded by the limited privilege would be meaningless.

E. *Congressional Response to the Lower Court's Decision*

Early in his tenure, former Internal Revenue Commissioner Jerome Kurtz proposed that corporate taxpayers identify in their tax returns any items treated in a manner contrary to a known position of the Service. *See* Kurtz & Panel, *Discussion on "Questionable Positions,"* 32 Tax Lawyer 12 (1978). This proposal immediately aroused an indignant public and Congress, *see, e.g.*, 123 Cong. Rec. 20870 (1977) (remarks of Rep. Crane), and no legislative action was taken to implement it. *See* Rankin, *Taxes and Accounting, Issue of Flagging Questionable Tax Items*, N.Y. Times, July 12, 1977, at 43, cols. 1-2. By demanding access to tax accrual workpapers which would flag corporate taxpayers' "questionable positions" for investigation, the Service here, and in a number of other cases, *see* Lyon, *Tax Investigations Revisited*, 29 Tax Lawyer 477, 482 (1975), apparently sought to put into effect through administrative policy former Commissioner Kurtz's suggestions for legislative action.

The Court below responded directly to the Kurtz proposals:

> [W]e are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, *The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 Colum. L. Rev. 1553, 1612 (1980). Procuring tax accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

(PA 31a, 32a)

Congress enacted TEFRA shortly after the judgment below was entered. Subsection (a) of section 6661 imposes a penalty for a substantial underpayment of tax but subsection (b)(2)(B) forgives it to the extent that the underpayment is attributable to items on which the taxpaper can establish that

"there is or was substantial authority for" its position* or (except for tax shelters) "with respect to which the relevant facts . . . are adequately disclosed in the return or in a separate statement attached to the return". Corporate taxpayers such as Amerada who seek and act on expert advice may well take positions which the Service will successfully challenge but which nevertheless fall within the purview of section 6661(b)(2)(B).

In enacting TEFRA, Congress must be deemed to have been aware of the decision below and the revised guidelines of the Service's Manual which impose restrictions on examiners' authority to summon tax accrual workpapers. *See Herman & MacLean* v. *Huddleston*, _____U.S._____, 103 S. Ct. 683, 689 (1983) (failure of Congress, in making substantial revisions in the securities laws, to amend certain overlapping remedial provisions of those laws, held to constitute ratification of well-established judicial interpretation of the provisions at issue); *see also Bob Jones University* v. *United States*, _____U.S._____, 103 S. Ct. 2017, 2033 (1983).

If Congress intended to require routine disclosure of an independent auditor's tax accrual workpapers or to eliminate or curtail the qualified privilege the Court below created, the 1982 revision of the tax laws provided an excellent opportunity to do so expressly. Congress did not seek to accomplish either objective. Instead, it chose to create a new, voluntary incentive to encourage taxpayers' full compliance with the Internal Revenue Code's reporting provisions. It also recognized that taxpayers should not be penalized for adopting positions which, while contrary to the Service's ultimate determination, rest on a sound legal foundation.

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*The Senate Finance Committee stated that the taxpayer could establish that there is or was substantial authority supporting its position by "showing good faith reliance on a professional opinion that [it] was more likely than not ultimately to prevail in any contest with the Internal Revenue Service." S. Rep. No. 494, 97th Cong., 2d Sess. 273 (1982) ("Senate Report No. 494"). *See also* 26 U.S.C. § 6661(b)(2)(B).

Section 6661 encourages disclosure of the relevant facts relating to "questionable positions" taken by taxpayers; it does not require disclosure of their judgments, doubts and uncertainties about possible tax liability. The statutory scheme also does not enlist public accountants as a new enforcement arm of the Service. As the Senate Report emphasized: "the Committee intends that the Secretary shall in no event require disclosure of accountants' workpapers." Senate Report No. 494, *supra*, at 274.*

Petitioner ignores the new provisions of TEFRA and insists that routine access to tax accrual workpapers is authorized by section 7602. Under petitioner's interpretation of section 7602, the Service had the authority to summon tax accrual workpapers and therefore force corporate taxpayers to disclose all their questionable positions long before TEFRA was enacted. This position, however, is untenable. Congress's adoption of section 6661 confirms that it did not believe that section 7602 by itself permitted the Service to require routine disclosure of "questionable" positions taken on a return by summoning tax accrual workpapers. When Congress decided to create a statutory scheme to encourage, rather than require, disclosure of questionable positions, it did so explicitly and with provision for good faith disputes.

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*The Conference Report accompanying TEFRA replaced the explicit language of the Senate Committee's Report with a brief direction to the Commissioner to prescribe the form of disclosure under "generally applicable regulatory authority." Conf. Rep. No. 760, 97th Cong. 2d Sess. 575-76 (1982). The proposed regulations, issued on March 15, 1983, shed further light on Congress's intent. The regulations set forth guidelines for the type of disclosure required under section 6661. They make no mention of requiring disclosure of accountants' workpapers. 48 Fed. Reg. 10862 (1983) (to be codified at 26 C.F.R. pt. 1). Moreover, the Service also recently issued a Revenue Procedure that further limits disclosure requirements by listing a series of exceptions to the proposed rule. Rev. Proc. 83-21, I.R.B. 1983-13, Fed. Tax Rep. (CCH) § 6457 (1983) In such circumstances, the Service considers a properly completed return, without reference to section 6661 and without further explanation, to be adequate disclosure. (*Id.*)

Consequently, it is petitioner, not respondents, who seeks a judicial modification of the Internal Revenue Code. Petitioner is attempting to enforce a summons for tax accrual workpapers for the purpose of compelling disclosure of the taxpayer's and its auditor's judgments and opinions—not facts—concerning Amerada's alleged "questionable positions on its returns." (Pet. Br. at 13, 43-44) This far exceeds the scope of section 7602 summons authority as limited by Congress in enacting section 6661.

F. *The Service's Recognition of the Rationale of the Decision Below*

Petitioner's position that disclosure of an independent auditor's tax accrual workpapers is essential to the Service's task of "insuring compliance with the tax law" (Pet. Br. at 27) cannot be reconciled with the Service's 1981 revised guidelines for requesting tax accrual workpapers. 1 [Audit] *Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).*

The revised guidelines require that, among other things, the following steps be taken before an examiner can consider requesting an independent auditor's tax accrual workpapers:

(1) the examination must be substantially completed;

(2) specific issues must be identified for which there exists a need for additional facts;

(3) all facts known to the taxpayer relating to the identified issues must be sought from the taxpayer in the first instance; and

(4) any supplementary analyses (not necessarily contained in the workpapers) of facts relating to the identified issues must be requested from the taxpayer's accountants.

(revised IRM § 4024.4(1), (2)) Only after these steps have been taken and the examiner determines that a need still exists to inspect the tax accrual workpapers can he seek written approval of his request by the Chief of the Examination Division. (revised IRM § 4024.4(5)) Even then, however, the

*The relevant provisions of the revised guidelines are set forth in Appendix B.

examiner's request will be "limited to those portions of the tax accrual workpapers that are material and relevant and related to the specific issue or issues identified." (Remarks of Commissioner Egger, *Daily Report for Executives*, DER No. 86 (BNA), *supra*, at J-1; *see* revised IRM § 4024.4(3)) Moreover, contrary to petitioner's admissions regarding the Service's purpose in summoning the tax accrual workpapers (*see* discussion *supra* at pp. 7-8), the director of the Service's Examination Division advised all technical personnel and managers in 1980 that the "examiner's interest in the 'items' that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of issues or the likelihood of success in litigation. . . ." *IRS Information Notice* 80-7 (Aug. 4, 1980) (issued by Mr. John L. Wedick, Jr.)

In effect, the Manual's instructions to examiners accord a qualified work-product privilege status to tax accrual workpapers. They require the Service to show a special need for the information contained in those documents by identifying "specific issues" and exhausting reasonable efforts to secure any needed factual information from other sources. The guidelines emphasize that the primary source of factual data is the taxpayer's records and that tax accrual workpapers are to be sought only when the facts relating to identified issues are not available from taxpayer records or supplementary analyses of facts prepared by the accountant. (revised IRM § 4024.4(1))

If the Service in other cases follows its own instructions to examiners and exhausts alternative sources of factual information, it will be in a position to overcome the qualified privilege announced by the lower Court. (PA 31a) Accordingly, the decision below has done little more than give effect to the Service's own guidelines.

Petitioner attempts to gloss over the revised guidelines. (Pet. Br. at 14-15 n.) While the guidelines strictly may not apply to this case,* petitioner advances no reason for ignoring

*The guidelines became effective after the summons for the tax accrual workpapers had been issued.

the Service's own decision to protect tax accrual workpapers against disclosure except in "unusual circumstances." (revised IRM § 4024.4) It appears that the Service is unwilling to abide by its own guidelines.* Judicial resolution of the conflicting public policy issues at stake in this case is required precisely because petitioner has chosen to press this as its test case for establishing the Service's power of unlimited discovery under 26 U.S.C. § 7602.

II.

THE DECISION BELOW MAY BE AFFIRMED ON ALTERNATIVE GROUNDS: THE TAX ACCRUAL WORKPAPERS ARE NOT RELEVANT TO A CIVIL AUDIT AND DO NOT CONTAIN PURELY FACTUAL DATA WITHIN THE SCOPE OF SECTION 7602

A party is entitled "to urge any grounds which would lend support to the judgment below," and this Court may consider them even if they were rejected by the lower court. *Dayton* v. *Board of Education*, 433 U.S. 407, 419 (1977); *see United States* v. *New York Telephone Co.*, 434 U.S. 159, 166 n.8 (1977).

A. *Relevance to a Civil Audit*

1. *The Proper Standard of Relevance*

The standard of relevance to be applied in enforcing section 7602 summonses has not been determined by this Court. In the absence of a definitive rule, the Court below invoked a "low threshold [test] of relevance" in holding that the tax accrual workpapers were subject to a section 7602 summons. (PA 27a) The majority concluded that "it is difficult to say

*Some district courts have permitted this inconsistency by ruling that the guidelines are non-binding, informal instructions to examiners which the Service is free to follow or ignore as it deems appropriate. *See, e.g.* United States v. I.C. Industries, Inc., 555 F. Supp. 219, 222 (N.D. Ill. 1983); United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999 (N.D. Ill. 1981); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 331 (D. Mass. 1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir. 1980), *cert. denied*, 449 U.S. 1021 (1981).

that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in [his] return would not throw 'light upon' the correctness of the return." (PA 27a) (quoting *Foster* v. *United States*, 265 F.2d 183, 187 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959)); *see also United States* v. *El Paso Co.*, *supra*, 682 F.2d at 537. ("It is, in fact, hard to imagine a document more likely to shed light on the correctness of those aspects of a return that harbor doubts than the tax pool analysis").

The lower Court's gloss on the meaning of "relevance" for purposes of section 7602 is in direct conflict with the decision of the Court of Appeals for the Tenth Circuit in *United States* v. *Coopers & Lybrand*, *supra*, 550 F.2d at 618, which held that an accountant's tax accrual files were not "relevant" to a tax investigation. Like the tax accrual workpapers here, the files in *Coopers & Lybrand* had been prepared solely for SEC and financial reporting purposes and not in connection with the taxpayer's return. (550 F.2d at 621)

In holding the tax accrual workpapers not relevant, the Court of Appeals for the Tenth Circuit relied in part on *United States* v. *Matras*, 487 F.2d 1271 (8th Cir. 1973), which denied enforcement of a Service summons for certain corporate budget forecasts. The Court in that case admonished that "the government should not, for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability, particularly where, as here, there is no indication of a purpose to escape any tax liability." (487 F.2d at 1275)

In *Coopers & Lybrand*, the Court recognized that the summoned tax pool analysis could assist the Service in its audit. Nevertheless, it held that "[m]ere convenience does not make an item producible under an IRS summons." (550 F.2d at 621) (relying on *Matras*) The Court emphasized that "extending IRS contentions . . . to their logical conclusion, it is hard to determine what corporate records would not fall under a § 7602 summons if the standard endorsed the production of *any* records which *might* show tax fraud or tax liability. IRS does not . . . have *carte blanche* discovery."

(550 F.2d at 619)* As a result, in *Coopers* v. *Lybrand* the Court held that the Service could not satisfy its burden of showing relevance "by alleging a general need for a 'road map' " revealing the soft spots in the return as detected by the taxpayer and its accountant. (*Id.*)

The Court below erred in not applying the stricter relevance test developed by the Eighth and Tenth Circuits. Enforcement of a Service summons should require a showing of "sufficient relevance"—not relevance in the abstract. *United States* v. *Harrington*, 388 F.2d 520, 523-24 (2d Cir. 1968). The "might-have-thrown-light-on-the-correctness-of-the-return" shibboleth is only the beginning of the relevance inquiry—not the entire analysis. The relevance test, for purposes of section 7602, should not always be a "low threshold." (PA 27a) Rather, it should be a matter of judgment and degree in light of the particular circumstances of the case. (388 F.2d at 524); *see generally*, Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax Rev. at 64-65.

The particular circumstances which must be taken into account in the determination of relevance include the degree of intrusion into a third party's files, the type of materials requested and a balancing of public policies with respect to disclosure. *See* Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 203-04 (1982).

For example, when a third-party summons (such as the one at issue) is involved, the Service must show something "of particularity concerning" its investigation—some reference to a "transaction which might possibly afford the realistic expectation necessary"—in order to obtain the requested

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*The Justice Department Advisory Committee on Tax Litigation reported that its members "agree with the decision in *Coopers*. All of the members of the Committee believe that if the IRS were to prevail in such a situation there would be no effective restraint against a 'fishing expedition' by the IRS." *Report by Justice Dep't Advisory Committee on Standards for Seeking Accountants' Tax Accrual Workpapers, supra*, DER No. 100, at J-10.

documents. *United States* v. *Goldman*, 637 F.2d 664, 667 (9th Cir. 1980), *aff'g* 453 F. Supp. 508, 512 (C.D. Cal. 1978); *United States* v. *Harrington*, *supra*, 388 F.2d at 523 (relevance for purposes of section 7602 requires a "realistic expectation rather than an idle hope that something may be discovered"). *See United States* v. *Powell*, *supra*, 379 U.S. at 57-58 (in order to meet its burden, the Service must specify how the requested documents relate to the "purpose of the investigation"); *United States* v. *Wyatt*, 637 F.2d 293, 301 (5th Cir. 1981) (relevance established by testimony of agent who not only gave "examples of the types of transactions to which the [Service's eleven] questions were directed and how such transaction would affect the taxpayer's income tax liabilities but detailed the need of the discovery and explanation of reported and unreported transactions.")*

The appropriate standard of relevance also depends on the nature of the documents summoned by the Service. The District Court in *Coopers & Lybrand* determined that when the "data sought are not records of transactions" or information "customarily . . . maintained in support of company transactions" but rather—as here—the "private thoughts and theories of the taxpayer" and its independent auditor, "the courts are prone to press the Service to a higher standard of relevance." (413 F. Supp. at 950). The Court concluded that the Service had failed to show that there was a "sufficient nexus between the information requested and the purpose for which it is summoned." (413 F. Supp. at 954). *See United States* v. *El Paso Co.*, *supra*, 682 F.2d at 548 (Garwood, J., dissenting) (in the context of a summons for an internal auditor's tax accrual workpapers, the relevance test of "throw light upon" means "throw *factual* light upon"); *United States* v. *Matras*, *supra*, 487 F.2d at 1272-73; *United States* v. *Luther*, 481 F.2d 429, 433 (9th Cir. 1973). In each of these decisions, it was the type of materials at issue—primarily

* Congress's special concern with third-party summonses is apparent from the procedural rights granted in section 1205 of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1699-1702, *amending* 26 U.S.C. § 7609. *See generally* S. Rep. No. 938, 94th Cong., 2d Sess. (1976).

projections, opinions, hypotheses of the taxpayer—which determined whether they were encompassed by section 7602.*

Finally, unlike the Court below, some courts have taken into account the various public policies affecting disclosure before determining relevance for purpose of section 7602. For example, in *Coopers & Lybrand*, the Court of Appeals for the Tenth Circuit considered the adverse effects of disclosure of tax accrual files upon the independent auditor-client relationship. (*See* 550 F.2d at 620 and 413 F. Supp. at 948-49) (*See* discussion *supra* at pp. 15-20) By applying a stricter standard of relevance, the Court in *Coopers & Lybrand* and other courts sought to balance the Service's need for information, the investing public's dependence on accurate financial reporting and the accountant's interest in safeguarding the confidentiality of his work product. *See also United States* v. *Arthur Andersen & Co.*, *supra*, 623 F.2d at 729 (determination of "relevance" should involve a "resolution sensitively reflecting the legitimate interests" of "all concerned—taxpayers, accountants, and IRS"—which would be "faithful to applicable statutes" and "would involve the most delicate and demanding analysis of facts, research of law and reflection on policy").

Similarly, in *United States* v. *Williams*, 337 F. Supp. 1114 (S.D.N.Y. 1971), *appeal dismissed and vacated*, 486 F.2d 1397 (2d Cir. 1972), the District Court held that a pyschologist's patient's message slips did not have to be produced even though they were held to be of "marginal relevance" because "of a burden on third parties that use of the requested message slips will impose." (337 F. Supp. 1116-17) In so ruling, the Court emphasized that mandatory disclosure of the summoned documents to the Service would interfere with the free flow of confidential information necessary for the conduct of a professional relationship. *See generally*, Note, *Government Access to Corporate Documents and Auditors'*

* In P.T.&L. Constr. Co. v. Commissioner, *supra*, the Tax Court held with respect to taxpayer discovery of the Service: "[w]hat is relevant is the *factual* information. . . . Mental impressions, legal analysis, conclusions and recommendations are generally not relevant." (63 T.C. at 414)

Workpapers: Shall We Include Auditors Among the Privileged Few?, 2 J. Corp. L. 349, 384-85 (1977). These broader policy concerns are particularly apparent in this case, which not only involves a burden to a particular taxpayer and a third party, but which will also have broad implications for all taxpayers and the accounting profession.

The Service itself has recognized in its revised guidelines that a routine civil audit does not require examination of tax accrual workpapers. In fact, the Internal Revenue Manual's requirement that the Service identify "specific issues" under investigation is an administrative analogue to the *Harrington* tests of "sufficient relevance" and "reasonableness" (388 F.2d at 523, 525). *See* 1 [Audit] *Int. Rev. Man., supra*, § 4024.4.

2. *Application of the Proper Relevance Standard to this Case*

Section 7602 provides that the Service can summon "any books, papers, records or other data" which "may be relevant or material" to "such inquiry," that is, "[f]or the purpose of ascertaining the correctness of any return" or "determining the liability of any person for any internal revenue tax." Congress's use of the term "inquiry" in section 7602 refers to the "subject matter inquired about rather than the process or performance of investigation to elicit the correct answer to the question." *United States* v. *El Paso Co., supra*, 682 F.2d at 546 (Garwood, J., dissenting). Accordingly, section 7602 requires a showing of "potential relevance to the *correctness* of a return or the *liability* of any person for a tax, as opposed to those [documents] the Service seeks merely because they have the potential of facilitating or making more efficient the process of examination." (*Id.* at 547) The Service here, as in *El Paso*, "clearly seeks the tax pool analysis for the latter purpose, not the former." (*Id.*)

That the tax accrual workpapers lack potential relevance to a civil audit, which the Court below assumed they have, is underscored by this Court's admonition in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), that "any presumptive equivalency between tax and financial accounting would be unacceptable.... Financial accounting ... is

hospitable to estimates, probabilities and reasonable certainties; the tax law . . . can give no quarter to uncertainty." (*Id.* at 543) The tax accrual workpapers are based on financial, not tax, accounting principles and thus have no specific relevance to the correctness of the return. (*See* discussion *supra* at pp. 2-3)

The Court below erred in not requiring the Service to demonstrate that it had a "realistic expectation" that the tax accrual workpapers bore a "sufficient relationship" to the correctness of Amerada's tax returns. *United States* v. *Harrington*, *supra*, 388 F.2d at 525. The Service relied on the affidavits of four employees, who recited only the theoretical relevance that the tax accrual workpapers might have to Amerada's tax liability. (*See* JA 11, 55, 57, 59, 98, 108) Under the "sufficient relevance" and "realistic expectation of relevance" tests, however, more is required. The Service's affidavits do not establish the requisite nexus between the independent auditor's tax accrual workpapers and the correctness of Amerada's returns.

B. *The Absence of Purely Factual Data*

The summons at issue raises a fundamental question of statutory construction: are the tax accrual workpapers included among the papers discoverable under section 7602?

Section 7602(1) permits the Service to summon "books, papers, records, or other data." The issue of what is meant by the generic term, "other data," in section 7602 was raised but not resolved by this Court in *United States* v. *Euge*, *supra*. No precise definition of the types of documents covered by section 7602 is provided in the Internal Revenue Code or its legislative history.* *See, e.g., United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976); *United States* v. *Brown*, 536 F.2d 117 (6th Cir. 1976). However, there is no indication in the legislative history of the Internal Revenue Code of 1954, its statutory predecessors, or regulations of the Service that the phrase, "books, papers, records, or other data," was

*The legislative history of section 7602 is examined in United States v. LaSalle Nat'l Bank, 437 U.S. 298, 310-311 (1978). *See* H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 436 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 617 (1954).

intended by Congress to include the kind of judgmental, evaluative material contained in the tax accrual workpapers. *See* Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra*, 51 J. Tax'n at 199; Diss, *The IRS and Auditors' Tax Workpapers: How Much is Too Far?*, Arthur Young J. 10, 18 (Summer/Autumn 1976).

The class of documents subject to discovery under 7602 must constitute "data" which, under either generally accepted usage or legal definition, means *factual* material.* No matter what the Service claims, the projections, hypotheses, speculations and private thought processes contained in the tax accrual workpapers do not consist of factual material.**

**See Webster's Collegiate Dictionary* 210 (1971) ("factual material used as a basis . . . . for discussion or decision"); *Black's Law Dictionary* 356 (5th ed. 1979) ("facts from which to draw a conclusion").

**This suggested construction of section 7602 finds substantial support within the Internal Revenue Code. Congress apparently intended to relate the section 7602 summons, section 7604 enforcement, section 7609 notification and section 7610 expense reimbursement provisions to the books of account and records which sections 446 and 6001 require to be maintained by taxpayers. *See* Diss & Hanson, *Tax Contingency Audit Workpapers: Current Developments, Observations and Proposals*, 12 Tax Adviser 104, 109 (1981); Diss, *The IRS and Auditors' Tax Workpapers: How Far Is Too Far?*, *supra*, Arthur Young J. at 18.

Sections 446 and 6001 and the accompanying regulations require the taxpayer to maintain permanent books of account and records sufficient to establish its taxable income, deductions, credits and other matters required to be reported on its income tax return. 26 C.F.R. §§ 1.446-1(a)(4) (1982); 1.6001-1(a) (1980). Moreover, district directors of the Service are empowered to require, by prior notice, that specific records be maintained to enable them to determine tax liability. 26 C.F.R. § 1.6001-1(d) (1980). Where no particular form of required records is specified, the records retained by the taxpayer must enable the district director to ascertain tax liability. *See, e.g.*, 26 C.F.R. § 1.6001-1 (1980) (employment tax records). Indeed, 26 U.S.C. § 7609(c)(3), which defines materials subject to a third-party summons, uses the term "records" to include "books, papers, or other data."

CONCLUSION

The decision below should be affirmed.

Respectfully submitted,

WILLIAM ELDRED JACKSON
1 Chase Manhattan Plaza
New York, N.Y. 10005
(212) 530-5000
Counsel for Respondent
Amerada Hess Corporation

Of Counsel:

RUSSELL E. BROOKS
JOHN C. MALONEY, JR.
MILBANK, TWEED, HADLEY
& MCCLOY
1 Chase Manhattan Plaza
New York, N.Y. 10005

ROBERT G. MORVILLO
OBERMAIER, MORVILLO &
ABRAMOWITZ, P.C.
1120 Avenue of the Americas
New York, N.Y. 10036

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APPENDIX A
AMERADA HESS CORPORATION

Subsidiaries (Not Wholly Owned) and Affiliated Companies

1. Anglomar Shipping Company Ltd.
2. Ariadne Co. L.P.
3. Artemis Marine Co. L.P.
4. Atlas Marine Co.
5. Bushehr Petroleum Co.
6. Conmar Terminals, Ltd.
7. D'Ippolito Oil Co.
8. Esperanza Petroleum Corp.
9. First United Shipping Corp.
10. Grandreunion Co.
11. Interocean Tanker Corp.
12. Matco Tankers (U.K.) Ltd.
13. Meadville Corp.
14. Oasis Oil Company of Libya, Inc.
15. Reserve Terminal Corp.
16. Second Reserve Terminal Corp.
17. Second United Shipping Corp.
18. Solar Gas, Inc.
19. South Jersey Terminal Corp.
20. St. Croix Petrochemical Corp.
21. Third United Shipping Corp.
22. Wyatt, Inc.

APPENDIX B

Internal Revenue Manual § 4024.4 (May 14, 1981) Guidelines for Requesting Audit or Tax Accrual Workpapers

(1) In unusual circumstances, access may be had to the audit or tax accrual workpapers. However, examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Accountants audit or tax accrual workpapers should normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data, access to which should be requested with discretion and not as a matter of standard examining procedure. For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts he/she may request the *audit* workpapers relating to the reserve for bad debts if those workpapers are determined to be necessary. Such a request should be made first to the taxpayer.

(2) Unusual circumstances, for this purpose exist under the following conditions:

(a) a specific issue or issues has been identified by the examiner for which there exists a need for additional facts; and

(b) the examiner has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s); and

(c) the examiner has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).

(3) In any case where the unusual circumstances in (2) above furnish a basis for requesting audit or tax accrual workpapers, the examiner should limit the request only to the portion of the workpapers believed to be material and relevant to the examination. Whether an item is considered to be "material" is based on the examiner's judgment and an evaluation of the facts and circumstances in the case. However, materiality does not depend entirely on amount. The concept

involves qualitative as well as quantitative judgments. For example, the significance of an item or its impact on the tax liability could be some of the factors to be considered in making a judgment regarding materiality.

(4) The reconciliation of Schedule M-1 must be made before considering whether it is necessary to request tax accrual workpapers. Guidelines for the reconciliation are contained in text 232.8 of IRM 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations.

(5) In situations where it is deemed necessary to request tax accrual workpapers in corporate examinations, the prior written approval of the Chief, Examination Division is required. When requesting information pertaining to the tax accrual, the examiner should first take all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information. This will require the examiner to question and where that is not successful to summons a financial officer or the tax manager of the corporation. See IRM 4024.5 concerning use of summons.